instantaneously to competition.[125] Perpetuating two such extremely different sets of rules thwarts competition instead of promoting it. Forbearance of the ILECs' interstate intraLATA services is therefore compelled by the Act.

Operator services surcharges. There are significant competitive alternatives in the market for operator services today that justify regulatory forbearance. For years, the operator services market has been very competitive. There were approximately 350 participants in the operator services and calling card markets in 1995.[126] Further, the ILEC revenue produced by operator surcharges is *de minimis* when compared to the total revenue produced by the overall market.[127] Finally, the 1996 Act ushered in a new era of competition, which has caused operator services to become even more competitive. End users can now choose a reseller as their local exchange service provider and the Commission and state regulators have ordered that calls requiring operator assistance that originate from resold lines be routed upon request to the reseller's operator services provider, adding yet another dimension to operator services competition.

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125 Indeed, nondominant carrier tariffs offering domestic, interstate interexchange services must be canceled during 1997. Policy and Rules Concerning the Interstate, Interexchange Marketplace, CC Docket No. 96-61, FCC 96-424 (rel. Oct. 31, 1996).

126 *See* Frost and Sullivan, 1996 Report, Chapter 3, "Total Operator Services and Calling Card Market," at 31.

127 It is impossible to accurately determine an ILEC's percentage of revenue, because there is no source for total industry revenues. GTE's revenues as reported in the Interexchange Basket for operator surcharges are very insignificant compared to overall interstate revenues in the CCB Long Distance Market Shares Report.

Directory Assistance. The FCC should also forbear from regulating directory assistance ("DA") in light of the competitive environment. GTE has lost a substantial amount of wholesale DA traffic to IXCs and alternative service providers, while retail DA is being lost every day to CLECs and new technologies. The proliferation of Internet service providers (and users) and personal computers has made possible a number of these competitive alternatives.

Today, ILECs compete in the wholesale market with providers like Excell Services, INFONXX, Metro One Communications, CFW, and many others. The ease of entering the market and gaining market share is evidenced by the growth of Excell Services, which started up in January 1995 with one customer and now has "over 200 operators handling directory assistance traffic" for three of the largest IXCs in addition to others.[128] Another example of competitive alternatives is Teleport's use of INFONXX's DA platform in the states where it operates so that it can be a self-provider. For example, Microsoft and several other software companies are currently producing and distributing CD ROMs that contain national residential, business, government (local, state, and federal) and specialty listings. In addition, non-traditional DA providers have successfully entered this arena by targeting high-volume DA users, and there are at least 100 Internet web sites that provide domestic, international, and specialty DA lists (*e.g.*, real estate, doctors, government).

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128 "Making Excellence in Directory Assistance a Custom," Business Wire, Aug. 12, 1996.

G. The FCC's Proposed Access Reform Alternatives Are Unworkable And Potentially Unlawful.

In contrast to a procompetitive, deregulatory approach to access reform (as would be consistent with the 1996 Act), the Commission proposed two alternative models — a "market—based" approach and a "prescriptive" approach — both of which would be counterproductive and highly intrusive. While a properly structured market-based approach (as proposed by GTE) would be sound because market mechanisms are the best means of aligning supply with demand for telecommunications services, the FCC's market-based plan is fatally flawed. That plan would unnecessarily delay the benefits of market-based pricing by establishing the triggers for such pricing based on criteria that are either irrelevant or unlawful. Moreover, the Commission's proposed prescriptive approach is entirely at odds with the procompetitive, deregulatory goals of the 1996 Act and is likely to result in an unconstitutional taking of ILEC property.[129]

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[129] The constitutional infirmities of these proposals are described in Section VI, *infra*.

1. The "market-based" approach is sound in theory, but ignores the Eighth Circuit's stay order and contains unduly dilatory or unnecessary triggers for its implementation.

Under the market-based approach, the Commission "would implement regulatory reforms as incumbent LECs demonstrate that their local markets have achieved pre-defined, specific transition points, or 'competitive triggers.'"[130] Specifically, there would be two competitive triggers, potential competition ("Phase 1") and actual competition ("Phase 2").

In Phase 1, when an ILEC is faced with potential competition for interstate access services in a specific geographic area, the Commission would eliminate (1) the prohibition against geographic deaveraging within a study area; (2) the ban on volume and term discounts; (3) the prohibition against contract tariffs and individual requests for proposals; and (4) miscellaneous restraints on the ability of ILECs to offer innovative access services.[131] In Phase 2, when an ILEC faces actual competition for interstate access services in a given geographic area, the FCC would (1) eliminate price cap service categories within baskets; (2) remove the ban on differential pricing for access among different classes of customers; (3) end mandatory rate structure rules for transport and local switching; and (4) consolidate the traffic-sensitive and trunking baskets.[132]

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[130] *NPRM,* ¶ 162.

[131] *See id.*, ¶ 168.

[132] *See id.*, ¶ 201.

Throughout this "trilogy" of proceedings, GTE has favored rational pricing; that is, the elimination of implicit subsidies in favor of market mechanisms to set the price for telecommunications services. Therefore, GTE endorses an approach to access reform that harnesses the laws of supply and demand to benefit the public. However, because the Commission's "market-based" approach considers factors that are unlawful, will invite delay, or are simply irrelevant, GTE cannot support this set of proposals.

a) The Phase 1 factors are inconsistent with the Eighth Circuit's stay order.

The FCC cannot use its jurisdiction over interstate access charges to overcome the legal infirmities in its *First Interconnection Order* by establishing compliance with that now-stayed order as a precondition to access charge deregulation. Specifically, the Commission cannot make the implementation of Phase 1 reforms contingent on the pricing of unbundled network elements based on geographically deaveraged forward-looking economic costs and wholesale pricing of retail services based on reasonably "avoidable" costs.[133] Such pricing plainly runs afoul of *Iowa Utilities Board v. FCC*, in which the Eighth Circuit stayed interconnection rules seeking to impose these same requirements.[134] Notably, in issuing the stay, the court cautioned that the TELRIC-based proxy rates "would result in many incumbent LECs suffering economic losses beyond those inherent in the transition from a monopolistic market to a competitive

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[133] *Id.*, ¶ 163.

[134] *Iowa Utilities Bd.*, slip op. at 10-11 (citing 47 C.F.R. §§ 51.503, 51.505, 51.513, 51.705, and 51.707).

one."[135] The Commission cannot use this proceeding to accomplish indirectly what the Eighth Circuit has initially determined that the FCC is not empowered to do directly.[136] A stay is equivalent to an injunction against enforcing the terms of an agency order.[137] If the FCC does adopt these requirements, it will be flouting this outstanding court prohibition against enforcing the *First Interconnection Order's* pricing rules and, at a minimum, demonstrating marked contempt for the court's authority.

b) The FCC should not delay implementation of its proposed Phase 1 access reforms.

As discussed in Section V.B., above, the Phase 1 reforms are critically necessary even in the absence of competition in order to promote efficient pricing. Allowing ILECs to geographically deaverage their access rates, lower access prices non-predatorily, and price new access services at market rates are all actions that will bring market discipline to the arena of access charges. Therefore, by implementing these reforms immediately, the Commission will take an important step towards the rationalization of access prices, and the American public will benefit accordingly.

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135 *Id.* at 18.

136 *See* Stadia Oil and Uranium Co. v. Wheelis, 251 F.2d 269, 275 (10th Cir. 1957) (citation omitted) ("[i]t is an old maxim of the law that a person will not be permitted to do indirectly what he cannot do directly"). *See also* Fentron Industries Inc. v. National Shopmen Pension Fund, 674 F.2d 1300, 1306 (9th Cir. 1982) ("The Fund and its trustees cannot be permitted to do indirectly what would be prohibited if done directly . . .").

137 *See, e.g.,* Virginia Petroleum Jobbers Ass'n. v. Federal Power Commission, 259 F.2d 921 (D.C. Cir. 1985); Licensing of General Category Frequencies in the 806-809.750/, 851-854.750 MHz Bands, 11 FCC Rcd 9707 (1995) ("The *sine qua non* for the grant of a motion for stay is a showing of irreparable injury that will result from the agency decision in the absence of injunctive relief.")

By delaying recognition of these benefits pending satisfaction of the proposed Phase 1 triggers, the Commission's approach would lead to anticompetitive consequences and prevent ILECs from recovering their legitimate costs. For example, continuation of the prohibitions on volume and term discounts and contract-based rates would retard competition by preventing ILECs from responding to marketplace movements. In addition, rigid rate structure rules would impede the introduction of new services and deny consumers the benefits of innovative pricing.

c) The additional proposed Phase 1 factors are redundant or unnecessary.

As a final infirmity, several of the proposed factors for concluding that potential competition exists are redundant or unnecessary. For example, the availability of transport and termination agreements, access to rights-of way, dialing parity, and long-term number portability are all ongoing legal obligations of all LECs under Section 251(b) of the 1996 Act and the Commission's Part 51 and Part 52 rules. Codifying them anew in the access charge rules would accomplish nothing. In addition, the proposed "open and nondiscriminatory" network access standard is too vague and open-ended to be a workable evaluator. Such an amorphous requirement has the potential to serve as a litigational sword in the hands of those parties that wish — for their own improper reasons — to prevent ILECs from pricing access services competitively. Finally, because interim number portability is sufficient to ensure that competition can constrain prices, the Commission need not wait until long-term number portability is in place.[138]

d) Phase 2 is flawed because it still subjects ILECs to regulatory restrictions despite the presence of actual competition.

Fatal flaws in Phase 2 of the "market-based" alternative confirm the imprudence of the entire proposal. According to the *NPRM*, when the Phase 2 test is met, ILECs will be faced with "an actual competitive presence for an exchange access service in a relevant geographic area."[139] However, they would will still be subject to a number of regulatory restraints, including, most notably, continued price cap regulation. If the Commission chooses to continue to regulate ILECs under such circumstances, it is hard to imagine when — if ever — the telecommunications market will be entirely deregulated.

Even if continued regulation were justified under these circumstances, which it plainly is not, none of the three possible factors for determining when an ILEC has met the Phase 2 trigger for "actual competition" — the demonstrated presence of competition based on a market share analysis;[140] full implementation of competitively

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138 Such delay would be particularly troubling because long-term number portability will be implemented on a rolling schedule based on the size of the market involved. Coordinating access reform with this implementation schedule would be both arbitrary and an administrative nightmare.

139 *NPRM*, ¶ 201.

140 *Id.*, ¶¶ 203, 204.

neutral state universal service support mechanisms; and the credible and timely enforcement of procompetitive rules[141] — is relevant to whether actual competition has arrived in a given telecommunications market. As an initial matter, the Commission itself pointed out a number of potential problems with the market share approach, including the economic and non-economic costs associated with gathering market share data, the difficulty in drawing conclusions about the state of competition from limited data, and the fact that market share-based regulation might affect how the market develops, contrary to the Commission's statutory mandate to allow competition, and not regulation, to shape markets.[142]

In addition to the defects recognized by the Commission, requiring an ILEC to demonstrate that a competitor has a certain market share demands far too extensive of a factual showing by the ILEC in question. Critically, market share is not necessarily related to the amount of competition that will "adequately restrain [the incumbent] from raising its prices."[143] That is, even with a negligible market share, competitors should be able to exert a significant disciplinary effect on the incumbent's rates, as large, sophisticated access customers seek out the most competitive service provider. Thus, predicating regulatory relief on a market share showing could prevent ILECs from adjusting their rates to market conditions, even when faced with actual competition. Moreover, the fact that an ILEC may retain significant market share in the local market

141 *See id.*, ¶ 202.

142 *See id.*, ¶¶ 203-204

143 *See id.*, ¶ 203.

does not mean that it is immune from competition in the access market. CAPs can capture significant access business even in the absence of local competition, given the concentrated nature of switched access demand.[144]

The second and third factors proposed by the Commission are likewise not determinative of the amount of competition in a particular market. Whatever the status of universal service or state enforcement programs, either competition exists, or it does not. In addition, requiring states to implement elaborate complaint resolution procedures would unduly burden the states while not necessarily advancing competition for interstate access services. Although GTE agrees that consumers must have a neutral forum in which to air their grievances against carriers, the existence of such fora has little to do with the state of competition for access services. Furthermore, it is fundamentally unreasonable to hold ILECs hostage to preconditions that regulators (not ILECs) must create and implement.

144 It is also virtually impossible for an ILEC to know its competitor's market shares since only those companies have this information.

2. Adoption of a prescriptive approach is anticompetitive and unnecessary.

Under the "prescriptive" approach to access reform, rather than relying on market mechanisms to reform access rate structure and levels, the FCC would "play a greater role in the telecommunications marketplace"[145] by determining the precise methodology that ILECs must utilize in pricing access services. Specifically, in order to reduce access charges to their forward-looking economic cost (including an allocation of forward-looking common costs), the Commission "seeks comment on the feasibility of readjusting the PCIs applicable to an incumbent LEC's baskets on the basis of a TSLRIC-based study."[146]

Such a prescriptive approach to access reform is antithetical to competition, will fail to meet the stated goal of efficient pricing, is extremely burdensome for both the Commission and the industry, and is unlawful. Basic economic theory and hard experience show that when state or federal regulators, rather than the market, set the price for a service, incorrect signals will be sent to new entrants. For example, if regulators price access services below the market price — as is the case with TSLRIC pricing — facilities-based entry will be discouraged and uneconomic arbitrage will be encouraged. On the other hand, if regulators price services above production costs, inefficient market entry will be encouraged, and when the market becomes entirely deregulated, a number of those new entrants will be forced out of business. Thus, the

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145 *NPRM*, ¶ 218.

146 *Id.*, ¶ 223.

Commission should be extremely wary of enacting a regulatory regime that substitutes regulators' decisions for market signals.

Not only will the proposed prescriptive approach wreak long-term damage on the market for access services, it will also place tremendous burdens on both regulators and ILECs. As the Commission recognized, either the FCC or state commissions must "evaluate incumbent LECs' TSLRIC studies for each price cap basket."[147] Developing TSLRIC studies is a complex and labor-intensive task that requires all concerned parties to produce and agree upon an enormous amount of cost data. As stated previously, additional significant burdens will be imposed if certain proposals are adopted, such as proposals to require some SS7 rate elements to be imposed on a usage-sensitive basis that require network modifications to implement. These burdens should not be undertaken in conjunction with an interim regulatory scheme.[148]

In addition, as fully documented elsewhere, repricing access services based on hypothetical TSLRIC would not compensate ILECs adequately, given that such pricing — by definition — fails to consider embedded and current actual costs.[149] These embedded costs, largely incurred at the behest of regulators, are real costs that must be recovered. Indeed, the Commission set the initial price cap rates based on fully distributed cost. If the Commission now intends to recalculate the PCI using TSLRIC pricing, it will have abandoned the price cap standard in an arbitrary and confiscatory

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147 *Id.*, ¶ 224.

148 *See* Section III.C., *supra*.

149 Sidak & Spulber address this issue in greater detail.

manner. If the Commission then refuses to allow the recovery of these costs in some fashion at the federal level, it must proceed through the Joint Board process to reallocate these costs to the intrastate jurisdiction. Doing so would foist this issue on state regulators, intrastate ratepayers, and the shareholders of the ILECs. Moreover, shifting such costs to the states would either necessitate increases in retail rates for residential customers or would result in irrationally priced telecommunications services if, for example, ILECs are permitted to raise their rates only for business services to make up for the shortfall in access revenues). Alternatively, if state regulators do not permit such cost shifting, failure to recover the shortfall would be an incontrovertible taking.

Moreover, the specific methodologies the FCC proposes to base a reinitialization on are seriously flawed. Basing a reinitialization on a 10 or 11.25 percent rate of return would force rates to uneconomic levels. An 11.25 percent rate of return was set in 1990 to reflect then current debt and equity levels in a market environment that reflected ILEC's monopoly status in many of their markets.[150] Today's market is dramatically different. As Dr. Vander Weide indicates, even an 11.25 percent return fails to take into account what shareholders expect to earn given the risk associated with ILEC businesses in the new competitive environment.[151]

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150 *See* Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, 5 FCC Rcd 7507 (1990), *recon.*, 6 FCC Rcd 7193 (1991), *aff'd,* Illinois Bell Tel. Co. v. FCC, 988 F.2d 1254 (D.C. Cir. 1993).

151 *See* Affidavit of James H. Vander Weide, attached to USTA Comments.

Reinitializing rates based on an adjustment of the productivity factor, or the consumer product dividend ("CPD") portion of the factor, is both illogical and economically unsound. The productivity factor has always been set to reflect a reasonable approximation of the degree to which, on average, an ILEC is expected to be more productive in the future.[152] In addition, the CPD was merely a mechanism to assign the first productivity gains to consumers, in an effort to balance interests between ratepayers and shareholders.[153] The Commission's proposals here are unrelated to these two rationales. The essence of price caps is to encourage ILECs to become more efficient by permitting them to retain profits they earn by becoming more efficient than the industry average. Adjusting the productivity factor on an arbitrary basis in order to force down rates is antithetical to this efficiency-producing aspect of price cap regulation. What is more, granting a portion of the ILEC productivity enhancements to competitors is unsound and confiscatory. Either of these two proposals will produce the same types of economic inefficiencies outlined in Section III, *supra*, such as promoting uneconomic market entry and sending incorrect pricing signals to the market.

Reinitializing price cap indices based on hypothetical TSLRIC studies or a rate-of-return prescription[154] would also destroy the efficiencies generated through price

152 *See Price Cap Second Report and Order*, 5 FCC Rcd at 6792.

153 *Id.* at 6796.

154 *See* NPRM, ¶ 228. The Commission plainly has not given sufficient notice in the *NPRM* to re-prescribe the ILECs' rate of return. The detailed access reform proposals, combined with the strict page limits and the brief time allowed for analyzing (Continued...)

caps and undermine the concept of incentive regulation. Under price cap regulation, ILECs can use pricing flexibility to earn a profit, as long as the prices for various baskets of services stay below the relevant ceiling. It is this profit motive, the Commission previously has found, that makes price cap regulation a good simulator of competition by encouraging efficient behavior.[155] This finding is just as true today as it was when price cap regulation was adopted.

Initial price cap indices were set based on rates that were established under rate base regulation. Since that time, the indices annually have been increased by an inflation factor, decreased by an industry-wide efficiency factor, and adjusted for exogenous costs. Therefore, ILECs each year have had to find ways to become more efficient. However, each year's profits are built on the efficiency measures taken in the previous year, dating back to the origination of price cap regulation. By reinitializing the price cap indices today, together with the continued threat that the FCC might reinitialize PCIs again in the future, the Commission would substantially undermine incentives to achieve greater efficiencies, destroy legitimate business expectations, and enervate current and future shareholder confidence in ILEC businesses.

(...Continued)
and responding to the *NPRM,* render it impossible to prepare and submit material relevant to a rate of return represcription.

155 *Price Cap Second Report and Order*, 5 FCC Rcd at 6787.

VI. THE FCC MUST PERMIT ILECS TO RECOVER ALL COSTS ASSIGNED TO THE INTERSTATE JURISDICTION. (*NPRM*, ¶¶ 247-270)

As clearly demonstrated above, the FCC must harmonize the competing interests implicated by the interconnection, universal service, and access reform "trilogy." In all of these proceedings, the FCC must allow ILECs to establish procompetitive and efficient pricing that recovers their legitimately incurred, actual costs. Moving from a highly regulated environment to a competitive one must be effected through fair rules to compensate ILECs for the consequences of federal and state regulatory decisions. GTE has described in these comments a detailed plan that accomplishes this end, while also promoting competition. If the FCC does not take these steps, it inevitably will embark on a collision course with both the Constitution and the Communications Act.

A. Unless Cost Recovery Mechanisms Are Instituted, the Access Charge Reform Proposals Would Result in an Unconstitutional Taking.

The Commission's access reform proposals, if implemented without modification, would violate the constitutional prohibition on the taking of private property for public use without just compensation.[156] In order to pass constitutional muster, the Commission must adopt rules which permit full recovery of prudently incurred costs that are assigned to the interstate jurisdiction.[157]

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156 U.S. Const. amend. V.

157 For a comprehensive analysis of access charge reform and its repercussions (Continued...)

Access charge reform creates a unique set of constitutional takings issues. ILECs are required to book all costs pursuant to the Uniform System of Accounts contained in Part 32 of the Commission's regulations. These accounts are then separated between the interstate and intrastate jurisdictions pursuant to the Part 36 rules, which were established by the FCC based on a Federal-State Joint Board recommendation. Access charges represent the vast majority of the funds available to compensate ILECs for these interstate-allocated costs. Yet the Commission's proposals would shrink access revenues while the ILEC's interstate costs allocated under Part 36 will remain virtually constant. ILECs cannot unilaterally reallocate these costs to the states and recover them through intrastate rates. Thus, ILECs will have no ability to make up for costs that the Commission itself recognizes are legitimate, or for under-recovery of past investment (resulting from uneconomic depreciation) or of future costs (resulting from a breach of the regulatory compact discussed below).

One of the principal purposes of the Takings Clause is to "bar government from forcing some people alone to bear public burdens which, in all fairness and justice should be borne by the public as a whole."[158] Traditionally, the Constitution has protected utilities subject to rate of return regulation from being limited to a charge for their property serving the public which is so unjust as to be confiscatory.[159] Whether a

(...Continued)
under the Takings Clause, *see* Sidak & Spulber.

158 Dolan v. City of Tigard, 114 S. Ct. 2309, 2316 (1994)(citation omitted).

159 *See* Federal Power Comm. v. Natural Gas Pipeline Co., 315 U.S. 575, 585 (1942).

taking has occurred depends on whether the utility had an opportunity to earn a fair rate of return on its prudent investment.[160] This regulatory contract permitted government to limit the utility's rate of return, in exchange for insulating the public utility from most market risks. Under this contract, ILECs have invested substantial sums pursuant to the expectation that they would be permitted to recover their investment over time and earn a reasonable return on their regulator-approved investments.

As a result of federal and state actions, ILECs are no longer protected from competition. On a going forward basis, therefore, it is appropriate to expose them to the risks and rewards of the market. With respect to past investment, however, denial of recovery — as would result from adoption of the access reform proposals without a new cost recovery mechanism — would breach the regulatory contract.

Importantly, the ILECs' entitlement to recover their embedded costs does not vary depending on whether the Commission adopts a "market-based" or prescriptive approach.[161] Under either approach, ILECs will be forced to reduce overall access charges and recognize a revenue shortfall, either by the artificial competition created by the FCC or by regulatory prescription. The ground rules have been altered, and it is this alteration — not the ILECs' ability to price access charges on a competitive basis in the future — that establishes the ILECs' right to recover that shortfall.

Likewise, the *NPRM* is wrong in suggesting that the availability of new sources of potential revenue from other lines of business may vitiate the ILECs' entitlement to be

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160 *See id.* at 602.

161 *See* NPRM, ¶ 256.

made whole for the under-recovery of interstate-allocated costs. Because these new markets are competitive, it can only be expected that such businesses will generate normal profits and certainly not the high levels of contribution that would be necessary to make up for losses in other lines of business. Moreover, the constitutional infirmity of disallowing recovery of the shortfall is not mitigated by the fact that ILECs may have other sources of revenue. In today's competitive marketplace, ILECs cannot be forced to carry out one regulated line of business (interstate access) at a loss simply because other lines of business may produce revenues. This would be tantamount to the government's forcing a regulated company to offer unregulated services in order to stay afloat while providing a below-cost regulated service. The Constitution does not condone such mischief.

Nor will the record support any allegations that GTE has investment allocated to interstate jurisdiction that can be used in other lines of business. GTE is in the long distance business as a reseller through a subsidiary separate from its ILEC subsidiaries. In the video services business GTE again has a subsidiary that is separate from its ILECs and that is building a new, separate video network. Any facilities or services obtained from a GTE ILEC comply with the requirements of GTE's Cost Accounting Manual. If GTE subsidiaries go out of their operating territories to compete for local service, they will do so on a deregulated basis and the Commission's recently issued rules in CC Docket No. 96-150 will require the separation of any commonly used investment.[162] The allegations that somehow excess investment

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162 Accounting Safeguards Under the Telecommunications Act of 1996, CC Docket (Continued...)

carried on the regulated books of GTE will be used to obtain profits in unregulated telecommunications businesses is simply a Trojan horse employed to hide the fact that there are no supracompetitive profits to be made.

In addition, the Commission must not limit the categories of costs eligible for recovery or compel ILECs to demonstrate that the investment at issue was prudent at the time it was made.[163] ILECs must have an opportunity to recover any investment that state or federal regulators allowed at the time the investment was made. GTE has long been subject to detailed regulatory oversight of its investment and, before the introduction of price cap regulation, had to obtain approval of capitalization plans and otherwise justify its expenditures. Following the implementation of price cap regulation, GTE has had strong incentives to maximize efficiency. Second-guessing the past actions of ILECs, state commissions, and the FCC is therefore both inappropriate and unnecessary.[164]

(...Continued)
No. 96-150, FCC 96-490 (rel. Dec. 24, 1996).

163 *NPRM*, ¶ 257.

164 Nor is there any basis for requiring state commissions to "conduct the necessary rate cases and to make recommendations to the Commission on possible disallowances of imprudently incurred investments or excessive expenditures." *Id.*, ¶ 258. Such a requirement is both unwarranted, since state commissions already have reviewed LEC investments, and exceptionally burdensome on state commissions and LECs. Cost recovery resulting from the reform of interstate access charges is a federal problem, and it should be dealt with at the federal level.

Similarly, the Commission should not limit ILEC earnings or impose greater. sharing obligations because of the transitional embedded cost recovery mechanism.[165] Doing so would penalize ILECs for competing effectively in the access market. For example, if an ILEC develops new access services that allow it to capture greater demand and earn a premium in the marketplace, it should not have to forego a portion of the resulting revenues simply because it is recovering past investment through the separate embedded cost recovery mechanism. Such a policy would create a disincentive to innovation and efficiency and would effectively deny the ILEC an opportunity fully to recover investments that have become devalued because of competition or technological change.

Finally, there is no basis for crediting arguments that ILECs should not be permitted fully to recover their costs subject to deferred cost recovery because they stem from inefficient investments. A significant portion of these investments was incurred under a rate of return regulatory regime prior to adoption of price caps. Under rate of return, these investments were approved by regulators as prudently incurred book costs. Indeed, in adopting price cap regulation, the Commission selected these rate of return price levels as reasonable starting points.[166] Even if some inefficiencies existed prior to the adoption of incentive regulation, the Commission found that price cap regulation "ensures that any inefficiencies embodied in the current rate of return

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165 *See id.,* ¶ 265.

166 *Price Cap Second Report and Order*, 5 FCC Rcd at 6816.

rates are eliminated over time."[167] Thus, the FCC has already concluded that the costs ILECs seek to recover here were efficiently incurred under the regulatory contract.

The sheer magnitude of the potential unconstitutional taking is staggering. The attached exhibit of Orville D. Fulp demonstrates that if the FCC decides to force GTE to price access at TSLRIC plus ten percent of common costs, it will have an interstate revenue shortfall of approximately $500 million in the first year alone.[168]

It is no answer to this constitutional dilemma that the ILEC can recover these interstate-allocated costs from future customers. It cannot. First, as indicated previously, with use of TSLRIC/TELRIC pricing principles in interconnection, universal service and access pricing, there is almost nowhere left to recover these remaining costs. States will object to inclusion of interstate-allocated costs in intrastate rates. Other services, such as interexchange services, are subject to competitive forces or produce insufficient revenues, which will preclude them as a source of recovery. What is more, ILECs cannot simply raise access rates to recover, e.g., past depreciation deficiencies, since the arbitrage potential from unbundled network elements and competition will preclude such action. The vast scope of this under-compensation, without the ability of ILECs to recover these costs elsewhere, would unavoidably result in a taking.

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[167] *Id.*

[168] *See* Fulp FCC Affidavit.

B. The Commission's Access Charge Proposals Also Run Afoul of Section 201(b).

In addition to the constitutional concerns outlined above, preventing ILECs from recovering the costs incurred supplying interstate access is also contrary to the Communications Act's mandate that rates be "just and reasonable,"[169] a provision unaltered by the 1996 Act. By eliminating the support for embedded costs and reducing rates to some estimation of incremental costs, ILECs will no longer be provided with an opportunity to earn a fair return on their investments.[170] The Commission has long held that rates must be compensatory to be considered just and reasonable under Section 201(b).[171] Moreover, in evaluating rates (even under price cap regulation), the Commission has consistently relied on carriers' embedded costs to determine reasonable pricing.[172] The FCC cannot simply ignore this long-standing precedent.

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169 47 U.S.C. § 201(b).

170 *See* Federal Power Comm. v. Hope Natural Gas, 320 U.S. 591, 602 (1944).

171 *See, e.g.*, TELPAK Proceeding, 61 FCC2d 587, 589, 606-18 (1976), *recon. granted in part and den. in part*, 64 FCC2d 971 (1977), *recon.* 67 FCC2d 1441 (1978); *id.* at 607 ("ascertainment of the actual cost of providing services underlies the requirement that rates be just, reasonable and nondiscriminatory.") Investigation of Access and Divestiture Related Tariffs, 57 RR2d (P & F) 188 (1984).

172 *See, e.g.*, authorities cited in n.171, *supra*; *Price Cap Second Report and Order*, 5 FCC Rcd at 6816; Amendments to Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, 6 FCC Rcd 4524, 4531 (1991).

C. If the Commission Does Not Permit Full Recovery of Interstate-Allocated Costs, It Must Utilize A Joint Board To Address These Issues and Ensure the Opportunity for Recovery in the Interim.

If the Commission ultimately determines that some costs should not be allocated to the interstate jurisdiction, it must convene a Joint Board to re-allocate these costs more fairly. Only in this way can the Commission save its proposals from constitutional infirmity and preserve its regulatory goal of future competitive access charges. Under 47 U.S.C. § 410(c), Federal-State Joint Boards are the Commission's sole mechanism for conducting "any proceeding regarding the jurisdictional separation of common carrier property and expenses between interstate and intrastate operations."

If the Commission does determine to seek reallocation of costs to the intrastate jurisdiction, it must adopt a mechanism to ensure that ILECs have the opportunity to recover their interstate costs pending final action by the Joint Board. Such a regulatory policy recovery mechanism, as discussed in Section IV.D. above, should address four areas: carrier common line costs (if not recovered from end users or the USF), separations misallocations (including residual costs currently recovered in the TIC), capital recovery, and a charge reflecting the short fall in local switching cost recovery engendered by either prescribed hypothetical forward-looking incremental costs or the "market" price levels established by unbundled network elements. This mechanism will prevent an unconstitutional taking, promote fair competition, and grant the Joint Board the time it needs to develop a strategy for handling these costs.

VII. CONCLUSION

For the foregoing reasons, the FCC should adopt GTE's proposal for access reform as outlined herein.

Respectfully submitted,

GTE SERVICE CORPORATION,
on behalf of its affiliated local exchange
and interexchange telephone companies

Gregory J. Vogt

R. Michael Senkowski
Jeffrey S. Linder
Gregory J. Vogt
WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 429-7000

Ward W. Wueste/gjv

Ward W. Wueste
Gail L. Polivy
1850 M Street, N.W.
Suite 1200
Washington, D.C. 20036
(202) 463-5200

Its Attorneys

January 29, 1997